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Ms. Victoria Saporta
Mr. Jesús Ibáñez
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Basel Committee on Banking Supervision
Basel, Switzerland

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Re: Comments on the BCBS consultative document on *Supervisory Framework for Measuring and Controlling Large Exposures*

Dear Ms. Saporta and Mr. Ibáñez:

The undersigned associations and our members appreciate the opportunity to comment on the BCBS consultative document on the *Supervisory Framework for Measuring and Controlling Large Exposures*. We support the BCBS's goal of having a consistent large exposures (LE) framework for internationally-active banks across jurisdictions. In regard to the proposals contained in the consultative document, we have the following comments that we would like the BCBS, through the Large Exposures Group (LEG), to consider.

I. Summary of main concerns and recommendations

I.1 Main concerns

Our main concerns relate to the proposed approaches to measuring exposures that are not consistent with established sound risk management practices, and are not reflective in a realistic manner of the worst case scenarios that the proposed LE framework aims to capture. Specifically, we have serious concerns about the following approaches in the proposed framework:

1. The required use of non-model standardized methods for calculating exposures;

2. The risk-shifting approach to capturing credit risk mitigation (CRM);

3. The economic interdependence criteria for connected counterparties; and

4. The look-through approach (LTA) for funds and securitization vehicles.

These proposed approaches will have the most significant impact because they substantially overestimate the potential losses that would occur from a single large counterparty default, rather than offer greater accuracy in capturing these potential losses. This is especially true for items 1 and 2. With regard to items 3 and 4, while we understand that the BCBS wants to promote robust exposure identification infrastructure in banks, we strongly believe that there are other ways to accomplish this goal without making the LE framework too complex to apply by banks and excessively difficult to be enforced effectively by supervisors, and without resulting in disproportionate implementation costs.

Moreover, since these approaches are not consistent with effective risk management practices, it is likely that they would be used only for compliance with the LE rule. This makes them operationally burdensome and might pose the risk of diverting management attention and resources from more critical and useful aspects of risk monitoring and management.

We are also concerned about the proposed lower limit for inter G-SIBs exposures. G-SIBs are already subject to more stringent regulation and supervision, in particular the additional loss-absorbing capital requirement and stringent recovery and resolution arrangements, as well as other regulatory measures that are in the process of being fully implemented. In addition, the entire derivatives and securities financing markets, in which G-SIBs are the main players, are undergoing substantial changes to strengthen their resiliency. These changes include central clearing for OTC derivatives and a review to improve liquidity in securities financing markets. Given these additional regulatory safeguards, we do not believe that a lower LE limit for inter G-SIBs exposures is either necessary or justified.

Aside from the very conservative approaches to measuring exposures and the lower inter G-SIBs limit, we are also quite concerned about the proposal to tighten the capital base used for setting the LE limit. In particular, given the fact that Basel III already made the eligibility requirements for capital instruments quite stringent, other regulatory measures should be adequately referenced to such capital instruments without adding further conservatism. It is our sense that with these proposals the BCBS might be pulling too many prudential levers simultaneously, resulting in a LE framework that is excessively conservative, complex, and not reflective of realistic peak loss scenarios. We believe the BCBS should consider the cumulative effects of all these changes in order to properly design and calibrate the LE framework[1].

In this regard, and to illustrate our point, the table below provides estimates of reduction in allowable exposures, which are simple yet useful indicators of the maximum impact of the proposals. For the top five G-SIBs identified by the FSB in November 2012[2], the estimates show

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[1] We also note that a significant portion of the framework – the revisions to CEM or new non-internal method (NIM),which will be required to be used by banks under the LE framework – is in the process of being developed and has not yet been published for comment. The NIM will significantly impact how exposures are measured and should be published for comment prior to finalizing the LE framework.

[2] *Update of group of global systemically important banks (G-SIBs)*, FSB, November 1, 2012

that aggregate allowable exposures to one counterparty will decline from $184.8 billion (using the existing 25% limit based on total capital) to $52.1 billion (using the proposed 10% limit based on core Tier 1 capital)[3], or an average reduction of $27 billion of allowable exposures per bank. Note that this applies only to the five banks' exposures to one G-SIB and that the same amount of reduction will apply to the five banks' allowable exposures to each G-SIB counterparty. Further, it should be noted that this calculation does not take into account the impact of the conservative measures we have identified above, which will surely compound the end effect of the framework that is being proposed by the BCBS.

The significant amount of financial activities that would have to be unwound or terminated to comply with the proposed framework would certainly impact market liquidity and loan capacity of the banking system, and eventually economic growth since it is unlikely that smaller institutions could readily assume all these financial activities. The proposed LE framework could also drive certain financial activities into less regulated sectors.

Aggregate allowable exposures to one counterparty for the top 5 G-SIBs under different LE limit and capital base (in billions of U.S. $)[4]:

LE limit	Core Tier 1	Tier 1	Total capital
25%	130.1	149.4	184.8
15%	78.1	89.7	110.9
10%	52.1	59.8	73.9

I.2 Main recommendations

We offer below several recommendations to address our main concerns, and which we hope the BCBS will find useful.

1. We believe that well-monitored, supervised, and reviewed measures based on internal models, such as the Internal Model Method (IMM) used for derivatives, better reflect the kind of risk that the LE framework wants to capture. Should a certain level of conservatism be desired by regulators or if model risk is a concern, an alternative to requiring the use of standardized measures is for regulators to prescribe certain inputs to internal models or require banks to stress their internal measures. For example, this would mean requiring the use of peak exposure measures based on IMM for OTC derivatives. For securities lending, this would mean providing supervisory inputs into simple value-at-risk (VaR) and other internal methodologies. However, if the BCBS still concludes that non-model measures are preferable to IMM (in the case of OTC derivatives) and that supervisory haircuts are the right approach (in the case of securities

[3] We used core Tier 1 capital instead of the Basel III CET1 capital because not all banks published Basel III numbers; using the latter would likely result in greater reduction
[4] Based on 2012 figures from published financial statements of Citi, Deutsche Bank, HSBC, JP Morgan, and Barclays

lending), the weaknesses of the existing Current Exposure Method (CEM) should be addressed and the supervisory haircut-based matrix should be updated and expanded to ensure better calibration.

2. Instead of a full risk shifting approach for CRM, the BCBS should consider a more targeted approach that only captures significant double default risk. One such approach is to apply risk shifting only to substantial (>2% of capital) underlier-provider pairs. For scenarios where there is a concentration of exposure to an individual non-bank credit protection provider, one possible safeguard might be to require detailed reporting of the underliers covered by the protection provider if the total protected notional exceeds a certain threshold. However, any measure that tries to address concentrations to non-bank credit protection providers should consider and be coordinated with the other regulatory initiatives that are underway to address the issue.

3. The assessment of economic interdependence should be done within the Pillar 2 framework. In addition, banks should be required to have policies and processes in place to monitor and manage connected relationships, with appropriate supervisory action in cases where these are not met. However, if the BCBS continues to include the assessment of economic interdependence in the Pillar 1 framework, we believe it should only be required if a materiality threshold is exceeded.

4. Rather than require the blanket application of the Look-Through Approach (LTA), national discretion should be allowed to look through certain vehicles, where the national supervisor deems it necessary using objective and transparent criteria. If the BCBS chooses to use a blanket LTA, we believe the threshold of 5% should be used. Alternatively, the higher threshold could be applied in relation to the underlying asset's materiality vis-à-vis the firm's capital. BCBS should also consider applying the LTA only to underlying assets that exceed the higher granularity threshold, not to all assets within a given vehicle.

5. We do not believe there is a need for a lower limit on inter G-SIBs exposures. G-SIBs are already subject to intensive supervision and additional sets of regulations that adequately address related prudential concerns. A different and lower limit for G-SIBs is not only unjustified but will result in unnecessary burden on the banks and unintended consequences on the market.

6. Given the stringent eligibility criteria for capital instruments under Basel III, Tier 2 (T2) capital should be included in the capital base. We also believe that the BCBS should recognize the loss absorbing characteristic of general loan loss provisions by including these provisions in the denominator of the LE limit.

II. Detailed comments

We offer below detailed comments and recommendations on the main concerns we have identified above. These are followed by our comments and recommendations on other elements of the proposals.

II.1 The use of standardized methods for calculating exposures

We reiterate the points we raised in our February 5 letter to the LEG:

> *We understand the LEG's reservations about using internal measures for LE purposes. However, as we noted in the meeting, for certain exposures such as derivatives these do represent the most appropriate values, not least because banks' current internal measures are significantly more robust and the governance much stronger than those used prior to the crisis. Lessons have been learned and revisions to the internal methodologies have been made to incorporate these lessons. In addition, internal measures are subject to rigorous validation processes, which include multiple internal checks as well as regulatory checks. Internal measures are also complemented by the use of stress testing. If the LEG still does not see merit in using internal measures, we urge the LEG to allow firms to use the internal models they have developed for regulatory capital purposes. These models have already been vetted by regulators and so should be appropriate for LE purposes.*

The BCBS points to model risk as the reason for not allowing internal models for LE purposes. However, the approach developed by the regulator is itself a model – a simple one that is likely to err toward conservative estimates. This creates the risk that transactions with economic utility may be precluded solely due to the conservatism arising from the election of a simple measure over a more accurate one. It should be noted also that oversimplification and conservatism reduces the ability of supervisors to distinguish between the actual levels of risk in each bank.

In addition, forcing banks to create an entirely separate process for large exposures that would neither be used for risk management nor for existing regulatory purposes would lend itself to increased operational risk given its lack of integration into firms' existing processes.

There are benefits to using regulator-approved internal measures that should be taken into account. Bank internal measures have undergone significant improvements since the financial crisis and now are subject to rigorous validation processes that must be undertaken before an internal measure achieves regulatory approval. They are also subject to ongoing internal and regulatory oversight applied through backtesting. Moreover, regulator-approved internal measures are already fully integrated into firms' management and control framework.

The same processes described above do not apply to standardized measures, which also become quickly irrelevant if not regularly updated. We have seen this in the many standardized measures that

are in place now – many of them are just recently undergoing review after many years (some more than a decade) of use.

II.1.a OTC derivatives

We appreciate that the BCBS proposes to allow the use of IMM until the new CEM is developed. Paragraph 58 of the consultative document clearly states the intent to use the successor to CEM for LE purposes once it has been approved. We are concerned that the successor to CEM has been pre-judged as better than IMM even before it has been fully developed, before its requirements are well-understood, and before there has been the opportunity for public consultation, including a thorough quantitative impact assessment.

Recommendation

We believe that if a bank has approval from its regulator to use the IMM for risk-based capital or other purposes, it should be allowed to use the same for LE purposes.

One alternative that we believe should be considered is to use peak exposure measure based on IMM. Paragraph 49 of the consultative document acknowledges that some banks use peak exposure measures rather than IMM regulatory capital numbers to manage derivatives exposures, but it does not explain why this should not suffice for LE purposes. Peak exposure based on banks' internal measure is also allowed for purposes of the FSB Common Data Template for Top 50 counterparties.

We believe that the IMM is still the best approach for LE purposes even if enhancements are introduced to the successor to CEM. However, if the BCBS still chooses to prescribe the successor CEM, the effectiveness of the new approach will require that:

1. It gives full credit to enforceable netting agreements. Any notional based calculations must provide for full notional netting within reasonably defined asset classes under a master netting agreement.

2. It incorporates a reasonable conversion of option notionals to their swap equivalents before netting.

3. It reflects the benefit of future variation margin receipts under enforceable master agreements. This would most likely be achieved by shortening the effective maturity to ten days and establishing PFE factors on that basis for netting sets covered by a margin agreement. PFE could be increased by the value of any variation margin threshold applicable under the margin agreement.

4. It gives credit in the calculation of PFE for initial margin. This is particularly important if supervisors insist that initial margin be charged for non-centrally cleared derivatives. Initial margin may be best implemented as a deduction from the PFE calculated using collateralized PFE factors described above.

II.1.b Securities Financing Transactions

Securities lending plays a critical role in the efficient functioning of global financial markets. It facilitates timely settlement, market making and hedging activities, increases market liquidity, and enhances the overall price-discovery process. It is also an important source of incremental revenue for buy-side investors (such as pension plans and mutual funds), that is used to help offset portfolio administration costs and improve investment returns. Banks have provided securities lending services to their institutional investor clients for many years under the careful supervision of prudential regulators. The LE framework should take into account the important role of securities lending.

The proposed BCBS approach overstates the risks in securities lending by applying haircuts to loan and collateral positions independently. This approach lacks risk sensitivity by failing to differentiate between "right way" and "wrong way" risks, fails to recognize the benefits of portfolio diversification or the impact of correlation between loan and collateral position, and presumes that all securities lending is "financing driven" rather than "demand driven."

As a result, the BCBS's approach will likely trigger a significant and unwarranted contraction in the securities lending market that could decrease both market efficiency and liquidity.

Recommendation

Banks that are active in the securities lending market typically use supervisory approved internal models to measure their risk exposures. We believe that banks should be allowed to continue to use such models for LE purposes. There are, nevertheless, alternative approaches that can be used to address model risk concerns. For example, regulators could prescribe inputs relating to asset volatility and asset correlation, as well as higher confidence levels, which would be used in banks' internal models. Alternatively, similar supervisory inputs could be used to construct an appropriately risk-sensitive haircut-based matrix. In some cases, the haircuts proposed by BCBS are now more than a decade old and are in need of careful revision to include greater granularity in terms of issuer ratings and across maturity profiles.

Banks that are active in the securities lending market have presented to national regulators the outlines of these various solutions, and we urge that they also be carefully considered by the BCBS. In the interim, we believe that it would be appropriate for BCBS to continue to allow banks to use their existing supervisory-approved models. This is consistent with the treatment of exposures to

derivatives, where the BCBS foresees the use of IMM until the successor to CEM has been developed.

II.2 Credit risk mitigation techniques

The notion of attributing full notional of credit protection back to the protection provider does not consider that the risk that the protection provider and the underlier fail simultaneously is quite remote. This risk remains low even if you introduce a high degree of correlation between the protection provider and the underlier. In addition, interbank CDS transactions typically consist of diversified pool of underliers (i.e., often times a counterparty provides protection on hundreds of different underliers), which further adds to the argument that it is very unlikely that every single one of the underliers and the protection provider will default simultaneously.

The requirement to attribute full notional of protection purchased back to the protection provider significantly overstates risk and disincentivizes banks to hedge their exposures. This could ultimately lead to more credit protection being provided by unregulated institutions.

Furthermore, it is common industry practice to collateralize daily all CDS transactions. This results in ongoing collateral movement from the protection provider to the protection buyer to cover any mark-to-market gains on the hedge as the underlier probability of default increases. Due to this daily movement of variation margin, it is unlikely that a bank would suffer a significant loss in the event of protection provider default. There is, however, a risk that a substantial amount of protection on an underlier is purchased from a protection provider. A more targeted substitution approach should be considered to address such risk.

We also would like to seek clarification on the interaction between the LE rule and the proposed rule on recognizing cost of credit protection purchased. Paragraph 45 of the LE consultative document states that "the scope of the large exposures framework should include any exposure that attracts a capital requirement under the risk-based capital standards." On the other hand, the proposed rule on recognizing the cost of credit protection requires that, for credit protection that is subject to the rule, the present value of the premium be risk-weighted at 1250%. This would imply that the present value of credit protection premium should also be captured under the large exposures framework. It is our view that this should not be the case since the present value of the premium does not add to the amount of losses that would be incurred if a single large counterparty defaults – which is what the LE rule aims to capture. Otherwise, it would only add to the already unduly conservative risk shifting approach for credit risk mitigants proposed under the LE rule.

Recommendation

Given the low probability of double default, we recommend that only substantial underlier-provider pairs be considered for substitution. Banks should only be required to substitute if the net

notional protection purchased on a particular underlier from the protection provider is larger than 2% of the bank's capital (substantial underlier). This proposed approach would capture single underlier-provider pairs that impose material loss in the event of double default. Limiting the required substitution to substantial underlier-provider pairs would also effectively capture any large exposures that might have to be re-hedged in the event of the protection provider default.

This approach can also be applied to collateral issuer risk substitution. Banks are required to recognize exposure to the issuer of the collateral received through either derivatives or securities financing transactions. Again, as the probability of double default is low, the loss can be material only if there is a substantial counterparty-collateral-issuer pair. Collateral issuer risk substitution is less of an issue if sovereign exposures are excluded from the rules. However, in the event that they continue to be in scope, we propose that banks only be required to apply collateral substitution after applying the 2% capital threshold test to counterparty-collateral issuer pairs.

We recognize that the substantial underlier proposal does not address a scenario in which concentrations to individual credit protection providers arise across multiple underliers that subsequently become correlated. For this scenario, one possible safeguard is to require detailed reporting to regulators of the underliers covered by an individual non-bank protection provider,[5] if the total notional amount protected by that provider, less collateral, exceeds a certain threshold, e.g., 15% of the bank's eligible capital. This would support regulators in the identification of future non-bank SIFIs and the build-up of risks outside of the banking sector.

However, it should also be noted that there have been significant steps taken after the crisis to address the risks posed by non-bank credit protection providers both at the international and national levels (e.g., derivatives reforms, FSB monitoring of shadow banking activities, establishment of entities specifically mandated to address systemic issues, etc.). Any measure that tries to address concentrations to non-bank credit protection providers should consider and be coordinated with these developments.

We are also concerned about the proposed blanket ban on physical collateral. We suggest that the LE framework should instead align with the risk-based capital framework where each supervisor can determine which physical collateral in its jurisdiction may be included, subject to the existence of a liquid market and publicly available market prices for the collateral.

Finally, we would urge the BCBS to clarify the interaction between the LE rule and the proposed rule on recognizing the cost of credit protection. As mentioned above, the present value of the credit protection premium does not add to the amount of losses that would be incurred if a single large counterparty defaults, and hence should not be included in the LE limit.

[5] Bank protection providers are already subject to stringent prudential regulations, and concentrations and interconnections would be captured by the LE framework, the FSB reporting requirements, and other regulatory measures in place.

II.3 Definition of connected counterparties

We believe that the definition of connected counterparties should be based on objective and consistent criteria. Hence, we do not think that subjective assessments of economic interdependence should be included in calculating a Pillar 1 limit on exposures. As we noted in our letter to the LEG in February:

> *Capturing indirect client relationships is quite subjective and very dependent on a strong understanding of the clients' business and business relationships. It is very difficult to make prescriptive rules that would adequately capture these relationships. For example, looking at implication of supplier relationship could be very industry specific and in some instances are dynamic in nature. In addition, as experienced with the rules currently in place in the EU, trying to capture "connected" entities is a highly manual, imperfect exercise […] In addition, the LEG should study the experience with the existing interconnectedness framework in the EU to understand the materiality and usefulness of the information being collected before it implements any new guidance.*

The qualitative judgments needed to determine economic interdependence could vary significantly across banks and jurisdictions, thus, leading to inconsistent implementation among globally-active banks. The BCBS has already started work on trying to narrow the divergences in calculated risk-weighted assets across banks and jurisdictions in order to aid a more consistent implementation of the Basel standards. Proposing an approach that would more likely lead to different interpretations and different approaches to implementation seems inconsistent with this objective.

We also believe that the costs associated with assessing economic interdependence far outweigh the benefits. Doing the assessment would be a complex process and yet the incremental exposures where connections are discovered would most likely not be material for most, if not all, banks. The complexity involved also does not meet the BCBS's objective of having a "simple large exposures framework."

As a practical matter, banks also do not have access to some information necessary to make these assessments, e.g., supplier information in most cases is proprietary to the firm.

Even if reliable and consistent capture/identification were possible, the maintenance of these connections, which can be dynamic or transitory, would be extremely difficult and labor-intensive, with little apparent gain. It is also possible that these changing connections could not be effectively captured in management reports.

Recommendation

In order to avoid making the LE framework overly complex without sacrificing the goal of capturing a reasonable level of interconnection between counterparties, control relationships must be defined or observed objectively and consistently (e.g., ownership of more than 50% of an entity's voting rights). This means that we support the use of a rules-based approach to defining control relationship but are of the view that a guidance-based approach is not necessary in setting a uniform Pillar 1 hard limit. This applies to accounting consolidation rules as well. The BCBS should only use objective, rules-based definition of control under accounting standards and should not consider the qualitative guidance to determining control as proposed under the last bullet of paragraph 32. It should be noted that the qualitative guidance in some accounting standards was informed by other objectives that are not consistent with the objective of the LE framework. For example, under the IFRS, there would be "control" if a company has the right to a majority of opportunities arising within another company even if this does not involve the assumption of any risk (for instance in the event of an exclusive profit sharing agreement without sharing the losses, or ABS structures with exclusive participation in the potential benefits without sharing the risks). For LE purposes, however, what is more relevant is the extent to which risks are shared.

Qualitative criteria of control relationships that may be appropriate to be included in the LE framework should be assessed under Pillar 2. The same goes for assessing economic interdependence. These assessments are quite reliant on subjective judgment making it hard to achieve consistent implementation, which is the goal of a Pillar 1 approach. Banks should also be required to have auditable credit risk management policies and processes in place to monitor and manage connected relationships that result in material exposures. Failure to have these policies and processes in place should result in closer supervisory scrutiny and, if deemed necessary, additional capital.

If the BCBS continues to include the assessment of economic interdependence under Pillar 1, it should only be required if a materiality threshold is exceeded. The concept of proportionality mentioned in paragraph 36 of the consultative document is ineffective. The onus is still on banks to examine the smallest of exposures and to determine if, on aggregation of these exposures, the 5% threshold would be breached. Proportionality would be better dealt with by requiring banks to investigate exposures for economic interdependence only if the size of the exposure exceeds a certain threshold (e.g., 2% of eligible capital).

II.4 Exposures to funds and securitization vehicles

The look through approach (LTA) for collective investment undertakings (CIUs), securitizations and other vehicles is quite burdensome and would require significant investments in banks' systems. Until these systems could be developed, it would require significant manual intervention.

The pro-rata exposure of a bank to the underlying assets in a CIU is frequently small, such that the operational burden of investigating it would not be commensurate with the prudential benefits of adding it to the exposure to the corporate in question.

For securitization, LTA is not appropriate given that built-in credit enhancement means that an investor is not exposed to the pro-rata share of the underlying assets. For example, a bank that holds a position in the senior tranche would only incur losses once the subordinated tranches were depleted. In the case of ABCP transactions, underlying exposures are typically to small and medium enterprises that are not large enough to be relevant in the LE context. Hence, the requirement to aggregate exposures even to these underliers will add undue burden without the commensurate benefit, and will penalize valuable transactions in the real economy. In addition, the proposal to consider the exposure as an exposure to the obligor (if LTA is not applied) is also not appropriate because securitization investment is non-recourse to the originator.

It should also be noted that securitization pools and investment funds are not always static and may be subject to change without the bank's consent. In addition, the disclosure on the underlying exposures in these vehicles can be infrequent and variable in its quality. So while we understand that the LTA is meant to incentivize banks to improve their exposure identification infrastructure, the result may be limited and not totally within the control of the banks. A likely scenario would be that many underlying assets could be deemed "unknowns" and aggregated as exposures to a single "unknown client." This does not really contribute to the understanding of the underlying risks.

Moreover, we believe the 1% threshold to determine whether a fund is "granular" or "non-granular" is too low for the following reasons:

1. There are many well-diversified funds where the largest underlying investments exceed this level.

2. The underlying investments in many managed funds are in equities, commodities, derivatives, investments in indices and bonds. These investments are accounted for on a mark-to-market basis. Consequently, investment volatilities could mean that a fund could move quickly from being "granular" to "non-granular". If bank funding is conditional on these reporting requirements being met in the event a fund becomes "non-granular" (to avoid a bank breaching its local regulatory large exposure requirements) and this triggers early repayment, this could have a material adverse impact on the financial position and liquidity of the fund.

3. The impact in 2 above would be compounded for dynamic portfolios where the mix of investments can change quickly.

4. In the securitization context, asset-backed securities which are granular on issuance may become "non-granular" after amortization (e.g., as the underlying receivables/mortgages are repaid).

Recommendation

Due to the reasons cited above, we have significant concerns about the application of the proposed LTA to all investments in vehicles and funds. We urge the BCBS to seriously consider not including this approach in the LE framework. One possible alternative might be to allow national discretion to look through certain vehicles, where the national supervisor deems it necessary using objective and transparent criteria.

Should the BCBS choose to adopt the LTA, we believe that the 1% threshold for determining whether LTA should be applied is too low. We propose a higher threshold of 5%, which we think would strike a better balance between the cost of administering the LTA and ensuring the effectiveness of the LE framework.

Alternatively, the focus of the threshold should not be on whether underlying assets are material relative to the fund/vehicle but whether they are material relative to the firm holding the CIU/securitization. In addition, the BCBS should consider applying the LTA only to the underlying assets that exceed the granularity threshold.

We also suggest that the most senior securitization tranches be exempted from the LE regime. This is to recognize the structural features of securitizations that reduce both loss probabilities and loss severity for the most senior tranches.

On the proposed identification of additional risks associated with CIUs, securitization and other vehicles, we think this needs further clarification given that it could potentially have punitive implications. Moreover, this approach can be seen as stretching potential outcomes beyond a realistic worst case scenario by capturing impact of fraud and operational risk. The ability of one entity to commit fraud upon another entity and cause its failure is not an issue that is normally addressed through the aggregation of the potentially fraudulent party within credit limit structures. Banks have separate processes and policies to address this problem. We urge the BCBS not to include in the large exposures framework elements that are outside the scope of how banks manage concentration risk.

II.5 Inter G-SIBs limit

We reiterate the points we raised in our February letter to the LEG:

> *SIFIs are already subject to more stringent regulation and supervision compared to other financial institutions. In the case of G-SIBs, for example, they are subject to additional loss-absorbing capital aimed at reducing their probability of default. G-SIBs are also subject to stringent recovery and resolution arrangements aimed at reducing losses to the financial system in the event of a G-SIB default. Given all these additional regulatory safeguards on SIFIs, we do not see any reason why exposures to these institutions should be subject to stricter limits.*

In addition, the Asset Value Correlation (AVC) used in calculating capital requirements for exposures to large financial institutions has been increased under Basel III. This is to take into account potential correlation and contagion among large financial institutions, which is also the same stated objective for having lower inter G-SIBs limits.

The lower inter G-SIBs limit is said to reduce interconnectedness in the system. However, this is duplicative of the G-SIB capital surcharge requirement because interconnectedness is already taken into account as one of the factors that determine the capital surcharge.

The lower limits on G-SIBs may have unintended consequence of exacerbating a crisis situation in which banks would normally seek a flight to quality. Inter-bank exposures include bonds, derivatives, certificates of deposit, credit protection facilities and short term uncommitted money market lines. If limits to G-SIBS are reduced, short term uncommitted money market lines are likely to be the most impacted. It cannot be assumed that the reduction in the availability of short-term money market lines to G-SIBs (typically high credit quality counterparties) will be replaced with equivalent lines to lower rated banks on a one for one basis. This could have a pronounced negative impact on liquidity in the interbank market, in both normal and stressful conditions.

Recommendation

We believe inter G-SIBs exposures should not be subject to a lower limit because of the reasons cited above.

II.6 Definition of eligible capital base

Basing the LE limit solely on CET1 or Tier 1 (T1) capital is a significant tightening of existing LE rules. Given that Basel III has made the qualitative requirements for capital instruments considerably more stringent, it is not clear why additional T1 (AT1) and even T2 capital should be excluded. For example, T2 capital instruments are required to include mandatory conversion or write-down features linked to the issuer's financial strength that are capable of absorbing losses on a "going concern" basis.

In addition, we do not find excluding general provisions in the LE limit appropriate given that these are held against future losses on the same exposures (albeit on an unattributed basis) that are

subject to the LE limit. Paragraph 43 explains why the BCBS excludes general provisions from the denominator of the LE limit: the LE rule is aimed at capturing unexpected losses but losses absorbed by general provisions are not unexpected. However, the exposure measure under the proposed LE rule does not differentiate between unexpected losses and expected losses that are covered by general provisions. Hence, we believe that all elements that are able to absorb the losses captured in the exposure measure – whether unexpected or expected – should be recognized. This would be the more symmetric and appropriate treatment of general provisions in the capital measure.

We would also like to note that the proposed changes in accounting rules to recognizing impairment losses would certainly increase the amount of general provisions and therefore the resources available to absorb losses. It is quite important therefore to recognize general provisions in the capital base for LE purposes.

Recommendation

We believe that the LE framework should include total regulatory capital. If the full T2 capital is not allowed for LE purposes, we believe that at least a proportion should be included to recognize its enhanced loss-absorbing features. This would also mitigate the significant reduction in allowable exposures that would result from tightening the exposure measure and, in the case of G-SIBs, lowering the limit. As an example, the approach under the CRR in the EU limits T2 capital to one third of T1.

However, if it comes down to a choice between CET1 and T1, we believe it is more appropriate to use T1. This would be consistent with the Basel leverage ratio, which is also a "backstop" measure.

We also urge the BCBS to recognize the loss absorbing characteristic of general loan loss provisions by including general provisions in the denominator (i.e., capital measure) of the LE limit. Including expected loss elements in the numerator (i.e., exposure measure) but not in the denominator would be not only asymmetric but also inappropriate.

II.7 Objective of the large exposure framework

The LE framework is meant to capture the loss that a bank would likely incur if a single large counterparty defaults. However, the current proposal adds the objective of capturing systemic risk arising from interconnectedness. There are already several regulatory measures in place and under consideration (e.g., additional capital for G-SIBs, recovery and resolution, FSB data templates, etc.) that are more appropriate tools to address the issue of interconnectedness. Adding the explicit objective of capturing interconnectedness will only duplicate the already numerous regulations on the issue. For example, one of the FSB templates is on the top 50 counterparties of banks. While the

FSB template is primarily a reporting requirement and not a prudential rule, the goal is for the official sector to be able to monitor interconnectedness in the system and to introduce prudential measures if and when necessary.

We suggest that the LE framework adhere to its original intended objective in order to make the framework as simple as possible – which is consistent with the stated intent of the BCBS.

Recommendation

One of the FSB templates records the top 50 counterparties of banks and, as such, is quite similar to LE reporting although the measures used are different. The industry has always advocated to have the two reporting requirements (LE reporting and FSB template on top 50 counterparties) aligned or merged in order to reduce operational burden on banks. If this is not possible, then the objectives of the two reporting requirements should be clearly delineated to ensure that there is no duplication of requirement for the same purpose. Hence, we suggest that the LE framework focus solely on capturing the loss that a bank would likely incur if a single large counterparty defaults, and allow the FSB templates to focus on interconnectedness.

II.8 Overall design of the prudential framework

II.8.a Definition of large exposures

The operational burden that the proposed conservative approaches to measuring exposures will introduce is compounded by the proposed LE reporting threshold of 5%. First, the conservative measures of exposure will lead to more counterparties being included in reporting. Second, the lower reporting threshold will force banks to monitor the exposures of a wider population (or even the whole population) of counterparties, even those below the 5% threshold, to ensure that a counterparty is reported once it hits the threshold. Closely monitoring counterparties with which the bank does not consider itself to have significant risk exposures is an inefficient use of risk management resources.

Recommendation

We suggest that the BCBS apply the 10% LE reporting threshold used in most jurisdictions. We also suggest a quarterly reporting frequency to align with similar existing reporting requirements.

We suggest that the definition of large exposure be dynamic, i.e., when there are relevant changes in bank structures as imposed by regulations, the calibrations should be revisited. For example, if bank restructuring proposals are adopted (e.g., Vickers, Liikanen), the reporting of >5% may prove burdensome and the hard limits (especially those for interbank exposures) in some cases could be problematic.

II.8.b Scope and level of application

The application of the limits may be unnecessary at the sub-consolidated level because, in many cases, these entities are already subject to national or state (in the case of the U.S.) lending limits. Accordingly, we ask that each jurisdiction be given flexibility to apply the limits at the consolidated level only.

II.9 Definition of exposure value

II.9.a Traditional off-balance sheet items

We appreciate that the BCBS has aligned the credit conversion factor (CCF) for trade finance with the Basel II credit risk standardized CCFs. This is quite important for both big international banks with significant trade finance business, and emerging market banks. However, we believe that banks should be allowed to use their regulator-approved internal measures to determine exposure amounts for all their traditional off-balance sheet items for LE purposes.

If BCBS chooses to use the supervisory CCFs, they should be aligned with the CCFs under Basel II for all traditional off-balance sheet items, not just for trade finance. We believe the 100 percent CCF is overly conservative. Traditional off-balance sheet items have conditionality or other associated restrictions that would prevent a full drawdown. As an example, regulated collective investment schemes (CIS), such as U.S. mutual funds, EU UCITS and other foreign equivalents face specific limits on borrowed funds and leverage. As demonstrated by banks' experience during the financial crisis, it is unlikely that committed facilities to regulated CIS will face incremental drawdown rates that approach even the lowest Basel II CCF.

II.9.b Trading book exposures

The consultative document does not allow netting of short and long positions where the short position is senior to the long position. The BCBS rationale is that a "peak exposure" would occur in the case of a partial counterparty default in which the junior long position experienced a 100% default but the senior short position experienced no default.[6]

We believe, however, that the LE framework should recognize netting of long and short positions in all financial instruments issued by the same counterparty for the following reasons:

1. Shorts increase in value as a counterparty moves closer to default, so even if the "peak exposure" occurs – 100% default on the long junior position, and no default on the short senior position – the short position will still have increased in value and provided an economic offset to the default of the long junior position. In addition, banks actively manage these positions, so

[6] Paragraphs 90-91 of the consultative document

as a counterparty's credit quality deteriorates, the bank is able to sell its long positions (decreasing in value) as well as its short positions (increasing in value) to offset one another, even if the seniorities are not matched.

2. Failure to recognize general netting benefits for short positions discourages banks from taking short positions that mitigate their counterparty risk exposures. As proposed, the rule would treat a completely unhedged long position the same as a long position hedged by a more senior short position. A better outcome would be rules that encourage hedging, even where the seniority match is imperfect.

3. As a practical matter, a "peak exposure" is a low probability event and therefore it would be unduly punitive to measure exposures based on this assumption. In a true crisis event, all categories of positions – equity, sub debt, senior debt – would decline in value, so recognition of short positions across maturity categories is a realistic reflection of risk. We think the proposed framework is focused on a very narrow and improbable risk scenario while penalizing risk management that would be helpful in the vast majority of circumstances.

Paragraph 95 of the consultative document states that netting of trading book and banking book positions should not be allowed, arguing that (i) banks separately risk manage these positions and (ii) "the wider regulatory approach in this area" does not recognize netting.

We believe, however, that the proposed framework should recognize netting between the trading book and the banking book for the following reasons:

1. Positions in the trading book and the banking book both reflect economic risk to the consolidated organization. If a bank has a $2bn loan in its banking book to a counterparty and has $2bn of shorts on the same counterparty in its trading book, these two positions are strongly correlated, even if not managed in the same portfolio. Permitting netting between the books presents a more realistic economic view of the consolidated organization's exposure to the counterparty.

2. The LE framework attempts to measure the potential losses that would arise from a default of a single large counterparty, and therefore it should be calibrated as accurately as possible to reflect economic risk at a consolidated level. The capital rules, by contrast, are calibrated differently because of the different goals and assumptions of these rules.

3. Contrary to the statement in the consultative document, banks commonly manage risk in the trading book and the banking book in a centralized manner, cognizant of the benefits of offsetting positions and hedges between the two books. Failure to recognize netting between the trading book and the banking book disincentivizes consolidated risk management.

Recommendation

We suggest that the LE framework recognize the netting of long and short positions in different issues by a single counterparty regardless of the seniority. If the BCBS continues to consider seniority in the application of netting, we propose that banks should be able to allocate securities based on their internal seniority bucketing approach, and not based on a regulator-determined bucketing.

We also suggest that netting between trading and banking books be allowed.

II.10 Specific exposure types

II.10.a Sovereign exposures

We suggest that national governments be given appropriate flexibility to include certain government sponsored entities or entities serving a public purpose to fall within the sovereign exemption (even if they are not technically public sector entities). These may include, for example, federal home loan bank exposures in the case of the U.S.

II.10.b Interbank exposures

To align with the stated objective of the proposed LE framework to follow the risk-based capital requirements to the greatest degree possible, LE limits should not be imposed on intraday exposures.

We support BCBS's consideration of allowing breaches in interbank limit under defined stressed circumstances. This treatment should also extend to corporate exposures. As experienced during the recent crisis, corporate bond and commercial paper markets in major jurisdictions became temporarily dysfunctional, making it difficult even for top-tier companies to secure funding through markets. It was the commercial banks that provided corporate funding needs at that time. While the LEG mentioned in our May 21 meeting that national authorities have the discretion to suspend any regulation if circumstances warrant, we suggest that the LE rule makes this explicit in the case of corporate LE limit as has been done for interbank exposures.

It should be anticipated that national supervisors will extend the scope of the framework to cover all banks, not just large internationally-active banks. For this reason, the proposals should take adequate account of these banks' needs. For these banks, the 25% limit will be reached relatively quickly in the interbank market. To ensure that smaller banks are able to continue to refinance themselves, we suggest that the BCBS consider applying a higher limit to these banks.

II.10.c Payment, clearing & settlement exposures

We welcome the BCBS's acknowledgment of the challenges faced by banks when providing custody and other similar services to their clients. These challenges include exposures resulting from failed securities transactions, the non-receipt or unanticipated movement of cash, the provision of various asset servicing functions and other routine transactional matters. In order to ensure the smooth and efficient operation of financial markets, we recommend that BCBS introduce a time-limited exemption for exposures that banks may incur when providing normal course payment, clearing and settlement services on behalf of their clients. One possible solution would be to rely on the framework that exists within risk-based capital rules, which provides for a five-business day window before unsettled transactions must incur a Pillar 1 capital charge. Under this approach, exposures resulting from payment, clearing, and settlement activities undertaken on behalf of clients would not be aggregated for LE purposes unless the transaction causing the exposure remained open for more than five business days.

II.10.d Exposures to CCPs

As we noted in our February letter to the LEG, the G-20 mandated global regulatory reforms seek to incentivize the use of CCPs for OTC derivatives. Establishing a regulatory limit on exposure to CCPs would therefore be contradictory to these reforms. In addition, there should be no differentiation in the treatment of qualifying CCPs (QCCPs) and other CCPs, at least in their formative stages. We are concerned that such differentiation may inhibit the establishment of new CCPs that may not initially qualify as QCCPs.

While we support reporting requirements for exposures to all CCPs, we believe there should be no hard limit for these exposures. Supervisors are best positioned to monitor exposures across institutions and address them through appropriate prudential measures. CCP developments are still in a state of flux and the final picture is not yet clear. We recommend therefore that BCBS allow flexibility on possible measures that would apply to exposures to CCPs.

II.10.e Intra-group exposures

We note that intra-group exposures have not been included in the proposed framework but we are concerned that for jurisdictions with an explicit limit on intra-group exposures, national regulators might introduce the new LE framework but retain the intra-group limit. This will compound the already considerable cumulative effects of the proposals and also lead to inconsistent LE framework across jurisdictions. We urge the BCBS to strongly seek consistency of LE framework among its members, especially as applied to internationally-active banks in order to avoid level-playing field issues.

III. Conclusion

In summary, we support the BCBS's efforts to harmonize LE rules across jurisdictions. We believe this can be done most effectively if (1) the objective of the LE rule is focused only on capturing the likely loss that would arise from a single large counterparty default; (2) the proposed changes are not viewed in silos but instead are viewed holistically in order to devise a properly calibrated and relatively simple framework; (3) the use of approaches that do not contribute to effective risk management yet do significantly restrict bank activity are avoided, or at least limited; and (4) the LE rule does not duplicate existing regulations in an effort to address issues best dealt with by other regulations, in particular issues related to G-SIBs.

We are appreciative of the opportunity to comment on the consultative document on *Supervisory framework for measuring and controlling large exposures*. Should you have any questions on the issues raised in this letter, please contact the undersigned (aportilla@iif.com, sally.scutt@bba.org.uk) or Jermy Prenio (jprenio@iif.com).

Very truly yours,

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